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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 1333

MISSOURI PACIFIC RAILROAD COMPANY,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Of Counsel:

Mark M. Hennelly
Gilbert P. Strelinger
210 N. 13th Street
St. Louis, Missouri 63103

Robert E. Simpson
1819 H Street, N.W.
Washington, D.C. 20006

Robert T. Molloy
1819 H Street, N.W.
Washington, D.C. 20006

Counsel for Petitioner

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IN THE

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OCTOBER TERM, 1970

No.

MISSOURI PACIFIC RAILROAD COMPANY,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Missouri Pacific Railroad Company prays that a writ of certiorari issue to review the judgments of the United States Court of Claims entered in the above-entitled case on June 12, 1970 and November 13, 1970.

CITATION TO OPINION BELOW

The opinion of the Court of Claims dated June 12, 1970, (Appendix B, *infra*, pp. 17-27) is reported at 427 F.2d 727 (1970) and that Court's opinion (Appendix C) of November 13, 1970, has not yet been reported officially.

JURISDICTION

The judgments of the Court of Claims were entered on June 12, 1970, and November 13, 1970. Petitioner's petition for reconsideration and rehearing was filed June 24, 1970, and denied on November 13, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTION PRESENTED

Whether a taxpayer sustains amortizable debt discount (original issue discount) upon its issuance of new debt securities for its own outstanding debt obligations and stock and the debt and stock of its subsidiary corporations, when the fair market value of the old debt and stock is less than the maturity value of the new debt securities on the day of the issue of such new securities.

STATUTES AND REGULATIONS INVOLVED

The statutory provision involved is Section 163 of the Internal Revenue Code of 1954 (26 U.S.C. 163) and Income Tax Regulation Section 1.163-3 promulgated by the United States Department of the Treasury. These sections are printed in Appendix A, *infra* p. 12.

STATEMENT

Petitioner is a corporation organized and existing under the laws of the State of Missouri and has its principal offices located in St. Louis. At all times here pertinent, petitioner was engaged in operating a common carrier by rail in interstate commerce and employed the accrual method of accounting.

Petitioner, along with its subsidiaries, was reorganized, effective March 1, 1956, pursuant to a plan of reorganization approved by the Interstate Commerce Commission and the Federal District Court having jurisdiction over petitioner's trusteeship under Section 77 of the Federal Bank-

ruptcy Act, 11 U.S.C. Section 205 (1964). Under this reorganization plan, petitioner issued its new Collateral Trust Notes, First Mortgage 4¼ percent Bond, Series A and B, 5 percent 90-Year Debentures and stock in exchange for its previously outstanding debt securities and stock and securities of its subsidiaries, which were merged with plaintiff as a part of said reorganization proceedings. In accordance with said plan and consummation order, upon consummation of the reorganization, the old outstanding debt and stock were retired and cancelled.

The aggregate maturity value of the new Collateral Trust Notes, First Mortgage 4¼ percent Bonds, Series B and C, General Mortgage Income 4¾ percent Bonds, Series A and B, and the 5 percent 90-Year Debentures issued under the reorganization plan was $529,117,141.00. The fair market value of the old securities and stock of petitioner and its subsidiaries, for which the new securities were issued, was $452,151,252.00 on date of the exchange. The difference between the maturity value of the new securities and the fair market value of the old was $76,965,889.00. Petitioner amortized this difference over the life of the new securities and claimed debt discount (additional interest) deductions of $1,027,372.00 for 1957, $1,023,325.00 for 1958, $1,018,760.00 for 1959, $1,019,453.00 for 1960 and $905,650.00 for 1961.

The Court below rules that the taxpayer was not entitled to amortize the difference between the maturity value of the new debt securities and the fair market value of the old securities for which it issued them. The basis for the ruling was that where the face amount of the new securities was equal to what was originally received by the taxpayer or its subsidiaries for the old, there is no discount. The Court recognized that in cases where the maturity value of the new exceeded what was originally received for old, discount would be available to the taxpayer. The Court below further held, in its decision of November 13, 1970, that in determining whether there was discount upon the exchange

of its bonds for stock of a subsidiary corporation, the value to be employed in determining discount was not the fair market value but the "equitable equivalent" as determined by the Bankruptcy Court in approving the plan for the exchange. Petitioner is contesting both holdings of the Court in this petition.

On December 10, 1970, petitioner filed a motion rehearing or reconsideration of the lower court's opinion entered with respect to one particular issue of bonds involved in petitioner's 1956 reorganization. However, it is petitioner's view that the lower court's action, which has not yet been entered pertaining to such motion, will in no way affect the direct conflict in circuit decisions which has been created by the lower court's decisions, entered on June 12, 1970 (Appendix B) and November 13, 1970 (Appendix C) and constitute the basis for this petition.

REASONS FOR GRANTING THE WRIT

1. The decision of the Court below is in direct conflict with the decision of the Third Circuit Court of Appeals in *American Smelting & Refining Company v. United States,* 130 F.2d 883 (1942). This conflict was conceded by the Court below in its opinion (Appendix B, p. 19, fn.). In *American Smelting,* the Third Circuit concluded that bonds issued in a face amount greater than the fair market value of the securities of its subsidiary, for which they were issued, gave rise to amortizable discount in the amount of such difference.

The decisions of the Court below are also in direct conflict with the decision of the Second Circuit Court of Appeals in *Nassau Lens Company v. Commissioner,* 308 F. 2d 39 (C.A. 2, 1962).

The need to clarify this area of the Federal tax law is further pointed up by the decision of the Third Circuit Court of Appeals in *Montana Power Company v. United States,* 232 F.2d 541 (1956). This case dealt with the

issuance of bonds for certain natural gas properties, and the Court concluded that the discount was not available to the taxpayer since the fair market value of the assets for which the bonds were exchanged was not established. During the course of the opinion, in discussing the application of discount amortization to situations in which the securities are issued for property, the seven judges had four different opinions as to when discount was proper. Judges Maris, Goodrich and McLaughlin felt that bond discount was available when bonds were issued in a face amount in excess of the fair market value of the property for which they were exchanged. Judges Kolodner and Staley felt that bond discount was not available where bonds were issued for property. Judge Hastie concluded that the discount was available where the bonds were exchanged for property but only in circumstances of arms length dealings. Chief Judge Biggs concluded that discount was available where bonds were issued for property even in the absence of a showing of fair market value of the property if a double tax would result in the absence of the allowance of a deduction for the discount.

This Court should resolve the conflict between the courts and resolve the confusion on this important area of the law.

2. The question presented is clearly important to the administration of the tax laws. The strained money market of recent years has made the use of discount more prevalent in financing arrangements particularly in the railroad industry because of a lack of incentive for equity investment. The position adopted by the lower court in its *Missouri Pacific* decisions, supra, is wholly inconsistent with the long-established Internal Revenue Service rules for determining the value of securities (Cf., § 2031, 1954 Code, and Treasury Regulations § 20.2031-2(b) and § 25.2512-2 (b)). Recently enacted legislation with respect to debt discount (Tax Reform of 1969, 26 U.S.C. 1232(b)) has no effect upon security transactions prior to May 27, 1969, so that there is a lasting impact on taxpayers due to the

fact that transactions not subject to the new legislative guidance remain subject to audit by the Government and the fact that the maturity dates and thus the amortization periods of debt discount for securities issued before May 27, 1969, will extend for many years in the future giving rise to considerable litigation until this matter is resolved.

3. The confusion in this area of the tax law, although having ramifications for all types of taxpayers, is particularly injurious to the railroad industry. As indicated by the divergent views and reasoning, relating to the debt discount problem, taken in the recent cases of *Atchison, Topeka and Santa Fe Railway Company v. United States,* D.C. Kan. 69-2 USTC paragraph 9740, *Gulf Mobile and Ohio Railroad Company v. United States,* D.C. Ala. 68-1 USTC paragraph 9358, and *Cities Service Company v. United States,* 26 AFTR 2d paragraph 70-5100 (July 24, 1970), the problem is national in scope and requires additional sophisticated review and resolution. Over the years, and particularly within the last two decades, a large number of railroads have had to undergo reorganizations in bankruptcy. Indeed, the extent of this phenomenon and the national concern involved finds recognition in the fact that special provisions (11 U.S.C. Section 205) have been enacted in the Bankruptcy Act to handle this class of person. As part of these reorganizations, new securities are invariably issued in exchange for the older outstanding classes of securities, with discount or additional interest being the inducement to the holders of the old securities to agree to the plan. Since discount is indiginous to railroad reorganizations, the tax impact of denying the deduction to the reorganized road during precarious post-reorganization periods defeats the purpose and hope of the reorganization.

The economic effect of the confusion in this area of law is particularly acute at this time due to the general liquidity problem that the railroad industry faces. The need to set aside funds to pay the additional taxes due from the dis-

allowance of amortization deduction diverts much needed cash from the operation of the roads.

Resolution of this issue would, therefore, have a salutory effect upon an important section of the economy.

4. It is petitioner's belief that the decisions of the Court below are erroneous and should be corrected by this Court.

What is involved in this proceeding is the exchange of new securities for old brought about by the need of the taxpayer to reduce the financial strain and pressure the old obligations were exerting. By refinancing its debt, the taxpayer extended the time for payment and allowed itself breathing time. As a part of the price for this additional time the taxpayer was required to issue new securities in a face amount in excess of the value of the older ones that were retired. The payment of a discount upon the issue of securities is not a novel experience but is the usual result where the interest rate called for in the bond is less than the going rate for the use of money in effect at the time of issuance. By keeping the rate of annual interest low and issuing the securities at a discount, the taxpayer could defer the actual payment of a portion of the interest to the time the new securities matured, when, hopefully, it would be well able to pay it. It is well settled that such a discount is amortizable by an accrual basis taxpayer such as petitioner, over the life of the new securities. *Deputy v. DuPont,* 308 U.S. 488, 498 (1940); *Helvering v. Union Pacific Company,* 293 U.S. 282 (1934); *Great Western Power Company v. Commissioner,* 297 U.S. 543 (1936); *Dodge Brothers v. Commissioner,* 118 F.2d 95, 103 (CA 4, 1941); Income Tax Regulations, Section 1.163-3.

The Court below saw a distinction, however, in the case where the new securities are traded for old securities rather than cash. Had petitioner issued its new securities in the face amount of $529,117,141.00 for $425,151,252.00 in cash, the discount being required because the market rate of interest was higher than that called for by the securities, and this $425,151,252.00 used to purchase the old securi-

ties, that being their fair market value at the time, there would be no question, even in the mind of the Court below, that the discount would be properly amortizable. But the Court below saw a distinction in the situation where the new securities were traded directly for the old securities with the intervening sale for cash eliminated. Thus, the petitioner is to be penalized in the computation of its Federal taxes for saving the expense of underwriting commissions, etc. involved in a public sale for cash. In view of the petitioner's financial condition at the time of issue, a sale for cash would undoubtedly have required a larger discount than was required in the exchange, if, indeed, the securities would have been marketable at all. Under the lower Court's view, bond discount would never be available to taxpayers going through an insolvency reorganization, with the result that those needing tax relief most would be the least likely to get it.

The lower Court's reliance upon the form of the transaction rather than the substance was improper and leads it to a seemingly inconsistency. At one point in its opinion (Appendix B, p. 19) the Court states in a footnote that it is not passing upon the question whether bond discount can arise where the bonds are exchanged for property and then states (Appendix B, p. 22) that it can arise in the instant case where the bonds in question are exchanged for bonds of its subsidiaries of a lower maturity value! The Court below thus carves out of the concept of property securities of a taxpayer's subsidiary corporation. There is no basis for such a construction in Section 163 of the Code, the regulations thereunder or the legislative history of the section.

The Court below also erred in its opinion entered on November 13, 1970, in that it concluded that in determining whether there is discount the "value to the taxpayer" of the stock received and not the fair market value is the proper measuring stick. The Court below relied upon the exchange ratio of the Bankruptcy Court as establishing the

value to the taxpayer. The Court below concluded that since the Bankruptcy Court approved a plan wherein $216.00 in maturity value of the bonds was the "equitable equivalent" of $250.00 worth of stock for which it was exchanged, there was no discount. In so doing, the Court below ignored the sales of the New Orleans, Texas and Mexico Railway Company stock in the open market at the time of the exchange.

In equating what was given with what was received, the Court effectively barred the finding of discount in any exchange of bonds for property by adopting the standard that what it received in exchange for bonds was equal to what it parted with in the bonds. By using the "value to the taxpayer" approach the Court below has introduced into an already confused area of law, a subjective standard which is incapable of measure by any known methods, thereby further compounding the problems of administering the tax law. It should be noted that if such a standard, with its dismissal of market value, was employed in the area of bargain sale, there could be no income in such situations, since it would have to be assumed that the purchaser received in value what he parted with in price regardless of the fact that similar property was being sold for several times that price in the open market.

Petitioner contends that proper standard for measuring discount is the fair market value of what was received in exchange for the security issued. It is the difference between the maturity value of the issued securities and the fair market value of what is received which measures the amount of discount.

The basis upon which the Bankruptcy Court approved a plan for exchanging the bonds for the stock, as used by the Court below, to determine the amount of discount, does not yield fair market value. Fair market value has traditionally been that price for which property would change hands in a transaction between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and

both being reasonably informed as to all relevant facts. An exchange of securities, as in this case, to a limited class of persons cannot be said to be the best evidence of fair market value. *Avco Manufacturing Corporation v. Commissioner,* 27TC547 (1956).

The ratio for the exchange of the bonds for the stock was based upon what the Bankruptcy Court considered to be the "equitable equivalent" and not the fair market value. Exchanges of securities under such circumstances will not establish a fair market value *Gillette Rubber Company v. Commissioner,* of 31BTA483 (1934). Whatever the value of such exchanges in other circumstances, no purpose is served by repairing to them where, as here, there are sales on the open market to establish the fair market value.

The general rule for determining what is received in an exchange where property is concerned is its fair market value. This rule applies to bonds as well as other forms of property. *Gerard Trust Company v. United States,* 166 F.2d 773 (3rd Cir. 1948). There is no reason why, in determining what amount of discount, if any, was involved the fair market value of the old securities should not be used in computing such discount.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

ROBERT T. MOLLOY
Counsel for Petitioner
1819 H Street, N.W.
Washington, D.C. 20006

Of Counsel:

MARK M. HENNELLY
GILBERT P. STRELINGER
210 North 13th Street
St. Louis, Missouri 63103

ROBERT E. SIMPSON
1819 H Street, N.W.
Washington, D.C. 20006

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C. 1964 ed.):

SEC. 163. INTEREST.

(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

SEC. 1.163-3 *Deduction for bond discount.*

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. ***

* * *

APPENDIX B

In the United States Court of Claims

Nos. 142–67 and 95–68

(Decided June 12, 1970)

MISSOURI PACIFIC RAILROAD COMPANY v. THE UNITED STATES

Robert T. Molloy, attorney of record, for plaintiff. *Mark M. Hennelly*, *Gilbert P. Strelinger*, *Gerald J. O'Rourke*, *Jr.*, and *Robert E. Simpson*, of counsel.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walters*, for defendant. *Ira M. Langer* (Case No. 142–67) and *Philip R. Miller* and *Theodore D. Peyser* (Case No. 95–68), of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON PLAINTIFF'S MOTION FOR PARTIAL SUMMARY JUDGMENT AND DEFENDANT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

COLLINS, *Judge*, delivered the opinion of the court:

This is a consolidated action[1] by the Missouri Pacific Railroad Company to recover, in addition to certain other

[1] This action is a consolidation of case No. 142–67 and case No. 95–68. Plaintiff's claim for debt discount deduction is the same in each case except that No. 142–67 is concerned with the taxable years 1957–58, and No. 95–68 relates to the years 1959–61.

claims,[2] the extra taxes which it had to pay as the result of its failure to receive a debt discount deduction for the years 1957–61. Both parties have filed motions for partial summary judgment in regard to the debt discount issue, so that this is the only issue before the court for consideration at this time.

Just recently in the case of *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. ——, 422 F. 2d 425 (Feb. 1970), this court grappled with the question of whether debt discount amortization would arise in instances where a corporation issued bonds in exchange for its own stock. We held that debt discount was not available in such a situation—especially since the face value of the bonds was equivalent to the amount originally paid for the stock. Our decision in *Erie Lackawanna* was limited just to the facts of that case, and we purposely avoided collateral issues such as whether debt discount would be available where bonds were issued for "other types of property," and whether debt discount would arise when the purchase price of the stock was less than the face value of the bonds. As a result of the instant case, we are now required to expand on our ruling in *Erie Lackawanna* and carry it several steps further.

Plaintiff is a corporation organized and existing under the laws of the State of Missouri and has its principal offices located in St. Louis. At all times pertinent to the issues in question, plaintiff was engaged in the business of operating as a common carrier by rail in interstate commerce subject to the jurisdiction of the Interstate Commerce Commission (ICC). For the taxable years in question, plaintiff was an accrual basis taxpayer and filed its federal income tax returns on the basis of the calendar year. Plaintiff, along with its subsidiaries, was reorganized, effective March 1, 1956, pur-

[2] The other claims which are involved in this action, but which will not be considered at this time are: (1) failure to allow a capital loss on the sale of an office building (No. 95–68); (2) improper treatment of corporate distributions as dividends rather than as a return of capital (Nos. 95–68 and 142–67); (3) failure to use the retirement-betterment method of accounting for the installation of welded track (No. 95–68); and (4) failure to allow plaintiff a foreign tax credit for taxes paid to the Republic of Mexico (Nos. 95–68 and 142–67). Also involved in case No. 142–67 was a dispute over how much tax credit plaintiff was entitled to receive in 1958 under § 1341 of the Int. Rev. Code of 1954 for refunds made to the United States of amounts reported as income under claim of right in prior years. This issue was resolved in favor of plaintiff by this court in the case of *Missouri Pac. R.R.* v. *United States*, 191 Ct. Cl. —— (Mar. 1970).

suant to a plan of reorganization approved by the ICC and the Federal district court[3] having jurisdiction over plaintiff's trusteeship under section 77 of the Federal Bankruptcy Act, 11 U.S.C. § 205 (1964). Under the reorganization plan, plaintiff issued: (1) collateral trust notes, (2) first mortgage 4¼% bonds (series B and C), (3) general mortgage income 4¾% bonds (series A and B), (4) 5% 90-year debentures, and (5) stock[4] in exchange for its own outstanding debt securities and stock and the outstanding debt securities and stock of its subsidiaries. As a result of this reorganization, the subsidiaries were merged into and became a part of plaintiff corporation.

The terms of the exchange varied among the holders of the debt and equity interests of plaintiff and its subsidiaries. For instance, in some cases the bondholders received new debt securities (often in various combinations) equal to the face amount of their old debt with the accrued and unpaid interest being paid in cash. Other bondholders received new debt securities in an amount equal to the sum total of the face amount of their old bonds plus the accrued and unpaid interest. The above-mentioned interest had accrued during the years plaintiff was in the process of reorganizing under section 77 of the Federal Bankruptcy Act. This accrued interest was deducted by plaintiff from its gross income for federal income tax purposes during the years in which it became due. In addition, plaintiff also took deductions for certain amounts of amortized bond discount relating to the old bonds. Once the reorganization became effective, all unamortized discount on the old securities was carried forward and amortized during the life of the new securities.[5]

Plaintiff's claim in this case is premised upon the fact that the aggregate maturity value of the new bonds issued pursuant to the reorganization plan was greater than the value

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[3] The plan was approved on March 1, 1956, by the United States District Court for the Eastern District of Missouri by Order No. 4710A.

[4] For purposes of the debt discount issue in this case, the value of the new stock issued as part of the reorganization will not be included in the total amount of property given up by plaintiff. Thus, the stock figures and any reference thereto will be eliminated from consideration for purposes of this decision.

[5] *See, e.g., Chicago, M., St. P. & Pac. R.R.* v. *United States*, 186 Ct. Cl. 250, 404 F. 2d 960 (1968), where this court gave its approval to the idea of carrying forward old discount and amortizing it along with new discount over the life of the new bonds.

of the securities received in exchange, as determined by New York Stock Exchange price quotations. Plaintiff alleges that the aggregate maturity value of the new bonds was $529,-117,141, while the fair market value of the old securities given in exchange was determined to be $452,151,252. The difference of $76,965,889 is the amount which plaintiff claims represents the debt discount deduction which must be amortized over the life of the bonds in question. Treas. Reg. § 1.163–3(a)(1), T.D. 6984, 33 Fed. Reg. 19175 (1968); *Helvering* v. *Union Pac. R.R.*, 293 U.S. 282 (1934); *Pierce Oil Corp.* v. *Commissioner*, 32 B.T.A. 403 (1935). Specifically, the instant case is concerned with the taxable years 1957–61. For each of these 5 years, plaintiff asserts that it was entitled to an amortization deduction in the amounts of $1,027,372 in 1957, $1,023,325 in 1958, $1,018,760 in 1959, $1,019,453 in 1960, and $905,650 in 1961. Thus, these are the amounts which form the basis for plaintiff's claim of recovery.[6]

The difference between this case and *Erie Lackawanna* is that, in the latter, debt securities were exchanged for the company's *own stock*. In this case, debt securities of the reorganized and consolidated company were exchanged for the company's *own bonds* and the *stocks and bonds of its subsidiary companies*. Consequently, the question now confronting the court is whether the rule of *Erie Lackawanna* should be extended to cover the types of securities just mentioned, or whether plaintiff's own bonds and the securities of its subsidiaries should be included in a category different from its own stock. Plaintiff urges that the old securities involved in this case should come under the heading of "other types of property," different from a corporation's own stock, and thus should be treated differently. Defendant argues that there is no real difference between a situation where a corporation exchanges debt securities for its own stock and where it exchanges debt securities for the stocks and bonds of its subsidiaries. For reasons to be hereinafter stated we agree basically with the arguments of defendant and render our decision in accordance therewith.

The basis of our decision in *Erie Lackawanna* was that when a corporation exchanged $100 face value bonds for its

[6] The above-mentioned facts have all been agreed to by stipulation of the parties.

own stock for which it had received $100, then it had really lost nothing as a result of the transaction. Plaintiff has tried to argue that we are not concerned with gains or losses (which involve a tax basis problem under sections 1012 and 165 of the Internal Revenue Code of 1954), but rather we are concerned with interest or "compensation for the use or forbearance of money" under section 163. *Deputy* v. *DuPont*, 308 U.S. 488, 498 (1940). We agree that debt discount is normally treated as interest under section 163, but we should point out that in some cases a debt discount deduction has been taken under section 165 which is the loss provision. *E.g.*, *Dodge Bros.* v. *United States*, 118 F. 2d 95 (4th Cir. 1941); *Atlanta & Charlotte Air Line Ry.* v. *Commissioner*, 36 B.T.A. 558 (1937). The distinction, however, is somewhat irrelevant since the amount of the deduction would be the same under either section. Therefore, for purposes of this case, we will accept plaintiff's approach and treat the debt discount as interest, deductible under section 163.

In essence, what this court was saying in *Erie Lackawanna* was that, in the exchange of bonds for stock, there was no difference in the values of what was given up and what was received. In other words, there was an exchange of equals, so that when the transaction was completed the corporation's financial situation had simply been rearranged, but it had not really been changed. The corporation had not obligated itself to pay out any more than it had already received. Consequently, we held in *Erie Lackawanna* that there was no amount which could be treated as interest and deducted as a debt discount. We now find that we are faced with basically the same type of situation as existed in *Erie Lackawanna*.

The main difference between the approach taken by this court in *Erie Lackawanna* (which will be followed today in this case) and that urged by plaintiff in this case is over the method of evaluating the property received for the new bonds. Plaintiff would have us determine the value of the securities received by it in exchange for its new bonds through the use of fair market value as determined by New York Stock Exchange price quotations. Just as we could not accept this method of valuation in *Erie Lackawanna*, where a corporation's own stocks were involved, so also we

cannot accept this method where a corporation's own bonds are involved. Fair market value is meaningless when attached to a piece of property which will no longer be subject to market conditions. It cannot be of any real significance in a situation such as this where plaintiff's old securities were immediately destroyed upon redemption. Instead, the face value of plaintiff's old bonds at the time of their issuance is the true valuation of these securities *as far as plaintiff is concerned. See Union Pac. R.R.* v. *United States*, 185 Ct. Cl. 393, 401 F. 2d 778 (1968), *cert. denied*, 395 U.S. 944 (1969). The fact that the fair market value of the old bonds may be less than the face value of the new bonds can in no way reduce the amount of value originally paid to plaintiff for the old securities. Consequently, for the court to say that plaintiff is entitled to a debt discount deduction because the fair market value of the old bonds is less than the maturity value of the new bonds is to give credence to an illusional or fictional interest charge which does not actually exist. For this reason, we cannot adopt plaintiff's method of valuation.

In addition, if we were to employ plaintiff's system of determining debt discount through the use of fair market value, it would appear that plaintiff would be unjustly increasing the amount of its deductions without correspondingly increasing its obligations. We have already conceded that plaintiff is entitled to carry over the discount from the old bonds. To then say that plaintiff is entitled to further discount as the result of the old bonds having a fair market value less than the face value of the new bonds would result in allowing plaintiff to increase the amount of its discount simply by substituting new obligations for old. We do not feel that a corporation should be allowed to increase the amount of its allowable deductions in such a manner, unless there truly is an increase in its bond indebtedness. Plaintiff has not been able to show that there is such an increase in this case.

We stated in *Erie Lackawanna* that, in the bond discount area, a corporation's own stock (and we have expanded this to include a corporation's own bonds by this case) comprises a category completely separate from cash and other types of property. The reason for this categorization should now be obvious. If plaintiff exchanged its bonds for some tangible

property such as the inventory of a corporation or even for the securities of another corporation, it would be understandable to value this property, for purposes of determining debt discount, through the use of fair market value.[7] However, there is a great deal of difference between this situation and one where a corporation receives its own stocks and bonds. Fair market value in the latter instance just does not have the same significance nor does it create the same result as in the former.

Having rejected plaintiff's method of computing debt discount through the use of fair market value and having placed a corporation's own bonds in the same category as its own stock, it now becomes necessary to determine how the stocks and bonds of a corporation's subsidiary should be categorized. Plaintiff would have us follow the reasoning of the United States Court of Appeals for the Third Circuit in *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3d Cir. 1942). In that case, the court ruled first that debt discount amortization would be available where stock of a subsidiary corporation was used as payment for the issuance of new

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[7] We do not mean to imply by this statement that we are now holding that debt discount is available where bonds are issued for property (other than the corporation's own securities). In fact, there appears to be a definite split of authority on this question with *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (2d Cir. 1962), and *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3d Cir. 1942), holding that debt discount is available where bonds are issued for property, and *Southern Natural Gas Co.* v. *United States*, 188 Ct. Cl. 302, 412 F. 2d 1222 (1969), *Montana Power Co.* v. *United States*, 141 Ct. Cl. 620, 159 F. Supp. 593, *cert. denied*, 358 U.S. 842 (1958), and *Montana Power Co.* v. *United States*, 232 F. 2d 541 (3d Cir.), *cert. denied*, 352 U.S. 843 (1956) (dictum), stating that debt discount is not so available. We are simply saying that, as between the situation where a corporation issues bonds for its own securities and where a corporation issues bonds for other types of property, we can better understand how fair market value could be applied to the latter situation but not to the former—assuming, for the moment, that debt discount would be available in the latter situation.

It should be pointed out that this problem may not arise in the future because of the Tax Reform Act of 1969, 83 Stat. 487. Both the House and Senate Reports have indicated that there may be original issue discount when a corporation issues a bond for a price less than its face value whether it receives cash, stock, *or other property* (including the assets of another corporation). Also, in a case where a bond is issued for property, it is provided that the issue price of the bond will be the fair market value of the property. S. Rep. No. 91-552, 91st Cong., 1st Sess. 148 (1969); H.R. Rep. No. 91-413 (Part I), 91st Cong., 1st Sess. 110 (1969).

We do not feel that such a provision would be detrimental to our decision in this case, especially in light of a Senate amendment which now provides that the issue price of bonds issued in reorganizations shall be the stated redemption price at maturity. Tax Reform Act of 1969, 26 U.S.C.A. § 1232(b) (1970).

debt securities by the parent. In addition, the court held that the cost of the debt securities should be determined by reference to the fair market value of the stock at the time of the exchange. Thus, once again, plaintiff would have us regard the securities of a subsidiary as property which should be treated differently from a corporation's own stock, and it also urges us once more to use fair market value as the means of determining valuation. However, we are unable to accept these arguments by plaintiff just as we are unable to accept the decision of the Third Circuit in *American Smelting & Ref. Co.* v. *United States, supra.*[8]

In the situation which exists in this case, where, prior to the reorganization, the subsidiaries involved were wholly owned,[9] there is no real difference between an exchange by a corporation of bonds for its own securities and those of its subsidiaries. The same general rule applies, namely, that the true value of the stocks and bonds *in the eyes of the corporation* is the original value of the securities, which value becomes a part of the assets of the parent corporation as the result of the reorganization and merger. Once again, to try and say that the cost of the new bonds is the fair market value of the old securities, at the time of the exchange, would be to create an interest charge that does not exist since the effect on the capital structure of the corporation would be the same regardless of the fair market value of the old securities. Consequently, we conclude that the securities of the subsidiaries involved in this case[10] should be treated the same as the securities of plaintiff corporation.

One point which we purposely failed to consider in *Erie Lackawanna* was whether debt discount would arise in a

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[8] This court has on two occasions specifically rejected the decision in *American Smelting & Ref. Co.* v. *United States, supra*—once in *Southern Natural Gas Co.* v. *United States, supra,* and again in *Montana Power Co.* v. *United States,* 141 Ct. Cl. 620, 159 F. Supp. 593, *cert. denied,* 358 U.S. 842 (1958).

[9] The two main subsidiaries involved in this case were New Orleans, Texas & Mexico Railway Company and International-Great Northern Railroad Company. Plaintiff owned approximately 94% of the common stock and all the preferred stock of New Orleans. (The remaining 6% was publicly owned.) New Orleans owned all the stock of International.

[10] The securities of the subsidiaries which are involved in this case are: New Orleans first mortgage bonds (series A–D), New Orleans common stock, International first mortgage bonds (series A–C), and International adjustment mortgage 6% bonds.

situation where the amount paid for the stock was less than the maturity value of the bonds. The corresponding issue in this case is whether debt discount will arise if the value of the old bonds is less than the value of the new bonds.

In examining the majority of the exchanges which took place as a part of the reorganization, it would appear that it would again be unnecessary to determine the answer to the above-stated issue. This is because in most of the transactions there was an exchange of items of equal value. For instance, in the exchange of new first mortgage 4¼% bonds (series B and C) for old Missouri Pacific first and refunding mortgage 5% bonds, and in the exchange of new collateral trust notes for old New Orleans, Texas & Mexico Railway Company first mortgage bonds (series A–D), there was an exchange of equal values of old and new bonds—with the accrued interest being paid separately in cash. In the rest of the transactions (except for two), there was an exchange of new bonds for old bonds to the extent that the value of the new bonds equaled the value of the old bonds plus accrued interest. Thus, again there was an exchange of equals, except this time plaintiff received an old bond plus a cancellation of interest indebtedness which together equaled the value of the new bond. In both types of transactions, plaintiff was receiving the equivalent of what it was giving up, so that there was nothing which could be deducted as interest.

However, based on the figures presented in the record, there appear to be two instances in which the exchange of bonds for securities was not equal. This occurred in the exchange of new first mortgage 4¼% bonds (series C) and general mortgage 4¾% income bonds (series A and B) for the publicly held common stock of New Orleans, Texas & Mexico Railway Company. The other instance involved the exchange of new first mortgage 4¼% bonds (series B and C) for old Little Rock & Hot Springs Western Railroad Company first mortgage 4% bonds. Assuming that the figures which we now have are correct, which indicate that there is a difference between the value of the new bonds and the amount received in exchange therefor, it becomes necessary to decide whether this difference should give rise to a

discount in light of the fact that this exchange was part of a corporate reorganization.

There is some authority to the effect that where there is a difference between the maturity value of the bonds and the amount received in exchange, and this takes place during a reorganization, then this difference should not be treated as debt discount. *Montana Power Co.* v. *United States*, 232 F. 2d 541, 549–50 (3d Cir.), *cert. denied*, 352 U.S. 843 (1956) (dictum); *New York, C. & St. L. R.R.* v. *Commissioner*, 23 B.T.A. 177 (1931); Rev. Rul. 59–387, 1959–2 CUM. BULL. 56. In the revenue ruling, the Commissioner of Internal Revenue held that where there was an issuance of 30-year debentures by a corporation for its own preferred stock, this was simply a recapitalization, and the preferred stock could not be recognized as assets in the hands of the corporation. Thus, considering the character of the exchange, the Commissioner did not feel that there was bond discount in the true meaning of the term. In *Montana Power Co.* v. *United States*, *supra*, three of the seven judges, in a dicta portion of the opinion, stated that an underlying theory of bond discount is that the transaction must be negotiated in the open market and at arm's length. They did not feel that such elements were present in a tax-free corporate reorganization.

Despite this authority, which is not exactly overwhelming in its strength or particularly persuasive in its approach, we find that bond discount can arise where there is a difference between what is given up and what is received, and this can occur in connection with a corporate reorganization. The fact that there is a difference in value between the bonds being issued and the securities being given up is enough to invoke the debt discount provision. The ultimate result of this difference is that the corporation is obligating itself to pay a debt which is greater in value than that which it is receiving. It seems irrelevant that what the corporation is receiving is its own securities, or that they will be destroyed because, in essence, these securities still have a value with the corporation, namely, their original cost. This original cost is still a part of the corporate assets and thus should be considered as the

actual amount paid for the issuance of the new bonds. Consequently, any difference between this amount and the maturity value of the bonds should be treated as a discount and amortized over the life of the bonds.

To summarize the conclusions of the court in this case, we hold:

(1) That for purposes of determining debt discount, the debt securities and stock of a corporation and the debt securities and stock of a corporation's wholly owned subsidiary, which are given up for a corporation's new bonds, should be treated alike.

(2) That when exchanged for new bonds, the above-mentioned securities should not be evaluated by the use of fair market value. Instead, the stocks should be given a value equal to the amount originally paid for them, and the value of the bonds should be determined by their maturity value as of the time of issue.

(3) That debt discount is available where the value of the stocks or bonds, as determined in item (2) above, is less than the maturity value of the debt securities for which they are exchanged.

Applying these rules, we find that, in the present case, there was no debt discount available in any of the exchanges which were a part of the reorganization—except possibly in two of the transactions. In regard to these two transactions, which involve the publicly held common stock of New Orleans, Texas & Mexico Railway Company and the bonds of Little Rock & Hot Springs Western Railroad Company, we do not have sufficient information to make a final decision. The record indicates neither the amount originally paid for the common stock,[11] nor the exact figures of the Little Rock transfer—especially the amount of accrued interest involved, if

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[11] In a letter to Mr. Roswell Magill from Mr. H. T. Swartz, Director, Tax Rulings Division, dated March 13, 1956, New Orleans, Texas & Mexico Railway Company was listed as having 148,329 shares of outstanding common stock at $100 par value. The schedule referred to in finding 8 of *Missouri Pac. R.R. v. United States*, 167 Ct. Cl. 725, 786, 337 F. 2d 637 (1964), lists the principal amount of this publicly held common stock to be $859,800. We are not certain whether either figure has any relation to the amount actually paid for the stock.

any.[12] As a result, we are remanding the case to the trial commissioner in order that he might compel the production of the data necessary to reach a final determination in regard to these two transactions. If the commissioner should find that there is a difference in value between the new Missouri Pacific bonds and the old securities given in exchange therefor, plaintiff will be entitled to a debt discount deduction in an amount which will be determined by the commissioner. If no such difference is discovered, then plaintiff will not be entitled to any discount deduction. In either case, unless the parties hereto stipulate in the interest of time, the commissioner shall report his findings to the court for final determination and judgment.

[12] There is quite a discrepancy between the figures in plaintiff's schedule A, attached to the order of the district court, and the schedule in *Missouri Pac. R.R.* v. *United States*, *supra*, relating to the exchange of Little Rock & Hot Springs Western Railroad Company first mortgage 4% bonds for Missouri Pacific Railroad Company first mortgage 4¼% bonds (series B and C). In plaintiff's schedule A, $1,510,246 worth of new bonds were exchanged for $1,140,000 worth of old bonds (as listed in the March 18th letter to Mr. Magill, note 11 *supra*). However, in the schedule in the *Missouri Pacific* case, $1,244,592 worth of new bonds were exchanged for a similar amount of Little Rock bonds. Because of this discrepancy, we feel the transaction should be examined by the commissioner.

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APPENDIX C

In the United States Court of Claims

Nos. 142–67 and 95–68

(Decided November 13, 1970)

MISSOURI PACIFIC RAILROAD COMPANY v. THE UNITED STATES

Robert T. Molloy, attorney of record, for plaintiff.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walters*, for defendant. *Philip R. Miller* and *Theodore D. Peyser*, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON DEFENDANT'S MOTION FOR REHEARING OR RECONSIDERATION

PER CURIAM: Defendant has asked us to reconsider part of our holding in this case. 192 Ct. Cl. ——, 427 F. 2d 727 (June 12, 1970).[1] The objection is to the conclusion, in our original opinion, that, when new bonds are issued for old stocks, debt discount is available where the amount originally paid for the old stocks is less than the maturity value of the new debt securities for which they are exchanged. We applied that rule to the publicly held common stock of New Orleans, Texas & Mexico Railway Company, and remanded the case to the trial commissioner to determine the amount originally paid by the taxpayer-plaintiff for that stock. The Government urges that this rule is not appropriate for an exchange of new bonds for old stock.

[1] Plaintiff has also filed a motion for reconsideration which is being denied today, by order without opinion.

Since our original opinion, a helpful decision has been rendered on this very point in the Southern District of New York. *Cities Service Co.* v. *United States*, 26 AFTR2d ¶ 70–5100, p. 70–5378 (July 24, 1970). Judge Mansfield there points out (26 AFTR2d at 70–5385) that the basic principle for the allowance of debt discount is that a "true loss", i.e., a detriment, must be sustained by a taxpayer issuing obligations payable at their face value at some future date, and that, if in fact the taxpayer receives a lesser consideration upon issuance than it will have to return at maturity, the difference is normally considered a debt discount in the absence of circumstances indicating otherwise. That is the general principle we followed in *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 422 F. 2d 425 (1970), and endeavored to apply in our opinion in the present case.

With respect to the particular problem of debt obligations exchanged for stock, the *Cities Service* opinion holds (26 AFTR2d at 70–5387) that the *minimum* amount the taxpayer may ascribe to the shares acquired by it for the new debt obligation is the original consideration, and "even if the market value of the shares at the time of the exchange had declined below their original issue price [taxpayer], would be precluded from claiming the decline in value as a loss because, having received the cost price upon issuance of the shares, it had not actually suffered a loss to the extent of the market decline." With this statement, we agree, of course.

The District Court then goes on to hold (26 AFTR2d at 70–5387), contrary to our original opinion in this case, that the original issue or cost price of the exchanged shares did not represent the ceiling value of the stock for the purpose of calculating debt discount. Its reasoning is that at the time of the exchange the shares could have a greater value to the taxpayer than the original issue or cost price. "Thus, where a taxpayer receives its own shares in exchange for issuance of its debentures, the value of 'what is received' for the purposes of determining the deductible loss or discount may be higher (though not lower) than the original issue price of the shares. The actual value to the taxpayer can be determined only after consideration of all relevant data, including the

market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects, and expert opinion."[2]

On reconsideration, persuaded by this *Cities Service* discussion, we hold that, with respect to shares of its own stock or stock in its subsidiaries, the present taxpayer cannot calculate, for debt discount purposes, the value of the stock at its cost or issuance price. That figure can be the floor but it cannot be the ceiling. The correct measure is the value of the New Orleans stock to plaintiff at the time of the exchange of the bonds for that stock.

In this instance, however, we need not order a trial to determine that value.[3] That determination has already been made. In taxpayer's reorganization proceedings, the value of the New Orleans stock was extensively canvassed before the Interstate Commerce Commission and the courts. See *Missouri Pac. R.R. Reorganization*, 275 I.C.C. 59, 113, 125–27 (1949); 290 I.C.C. 674, 678–79 (1954); *In re Missouri Pacific R.R.*, 93 F. Supp. 832, 848–49 (E.D. Mo., 1950), 129 F. Supp. 392, 399 (E.D. Mo. 1955); *State of Texas* v. *Group of Institutional Investors*, 191 F. 2d 265, 273–74 (8th Cir. 1951) *cert. denied*, 342 U.S. 904 (1952); *Missouri Pacific R.R. 5¼% S.S.B.C.* v. *Thompson*, 229 F. 2d 898, 900–01 (8th Cir. 1956). The final reorganization plan, which was confirmed and adopted, found the stock to be then worth $250 per share, but only $216 in maturity value of the bonds was allocated to each share, as the "equitable equivalent" of the $250 value. *Missouri Pac. R.R. Reorganization*, *supra*, 290 I.C.C. at 678–79. Thus, the value of the New Orleans stock, at the time of the exchange, has authoritatively been found, after considerable and careful inquiry (including expert testimony), to be not less than the maturity value of the bonds exchanged. *Cf. Arkansas-Missouri Power Corp.* v. *Paschal*, 243 F. 2d 584, 588 (8th Cir), *cert denied*, 355 U.S. 835 (1957).

The fact that the stock was selling for less on the stock exchange is not at all conclusive (*Cities Service Co.* v. *United States*, *supra*, 26 AFTR2d at 70–5387), and in this case is

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[2] The opinion emphasizes that the market price would be relevant but not conclusive, and that the significant figure is that "representing the value to plaintiff [the taxpayer] of the shares in question."

[3] In *Cities Service*, a trial was directed.

clearly outweighed by the other factors which led the Interstate Commerce Commission and the federal court to find and determine that the new bonds were a "fair and equitable" equivalent for the New Orleans stock. There was, therefore, no debt discount on the issuance of the bonds since the plaintiff-taxpayer received at least the equivalent (in stock value) of the maturity value of the bonds.

This conclusion calls for a modification of our prior holding and opinion. The exchange involving the New Orleans stock falls into the same category as the majority of the transactions dealt with in that opinion—there was no debt discount on the transaction—and there is no need for a remand. The remand ordered in our prior opinion is, accordingly, restricted to the transaction involving the Little Rock bonds. In addition, the last portion of our prior opinion, 192 Ct. Cl. ——, ——, 427 F. 2d at 732–34,[4] is modified to refer only to bonds and other debt obligations, not to stock, insofar as the holding is that the original value of the securities must be looked to for the purpose of determining whether a bond discount exists. The few references in that opinion to the original cost of shares of stock as determinative are stricken and replaced by the standard of the actual value of the stock to the taxpayer at the time of the exchange. It goes without saying that, with respect to bonds exchanged for bonds, the opinion still stands as written.

To the extent indicated in this opinion the defendant's motion for rehearing or reconsideration is granted and our prior decision and opinion are modified.

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[4] Beginning with the sentence (slip op., p. 8), "The same general rule applies, namely, that the true value of the stocks and bonds *in the eyes of the corporation* is the original value of the securities, which value becomes a part of the assets of the parent corporation as the result of the reorganization and merger," and continuing through to the end of the opinion.

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